

Central Intelligence Agency



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DIRECTORATE OF INTELLIGENCE

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South Korea's Economy: Shifting Out of Overdrive [REDACTED]

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Summary

After two years of double-digit real growth in GNP, the South Korean economy is beginning to settle into what we expect will be a still strong performance, providing an annual economic growth rate in the 6- to 10-percent range in the 1990s. In our view, the rising value of the won, a slowdown in foreign demand for many South Korean exports, and higher domestic wage costs will all brake the economy. Seoul's current account surplus for 1988 could surpass the almost \$10 billion record chalked up last year, as declining interest payments on foreign debt and tourist revenues generated by the Olympics more than offset a modest drop in the trade surplus. Over the longer term, however, we expect the surplus will fall. [REDACTED]

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This memorandum was prepared by the Office of East Asian Analysis. Information available as of 25 April 1988 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Korea Branch, Northeast Asia Division, OEA [REDACTED]

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The Economic Boom Completes a Second Year

Preliminary figures released by the Bank of Korea show that the South Korean economy grew by 12.2 percent in 1987. Moreover, had it not been for strikes that temporarily paralyzed industry last summer, growth would have reached an all-time high. A major reason for the good showing was a surge in exports caused by favorable exchange rates--between September 1985 and the end of 1987 the won appreciated only 16 percent against the US dollar, compared with 41 percent for the New Taiwan dollar and 67 percent for the Japanese yen. A rapid rise in domestic investment also boosted growth. Much of that investment was in the auto industry, which increased output by 63 percent and exports, mostly to the US market, by 57 percent. [redacted]

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The Outlook for 1988 and Beyond

The Korean Economic Planning Board has set 8 percent as its target for growth this year. Like private forecasting services such as Wharton Econometrics--which expects GNP growth to drop to 7 percent--Seoul appears to be assuming that demand for Korean exports will slacken as consumer spending slows in major Western economies. We have yet to see any clear indications that demand is subsiding, however, and believe Korea's growth rate may be closer to 10 percent in 1988. [redacted]

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Auto and electronics exports, for example, started the year strongly. Auto exports were up 87 percent and electronic exports rose 54 percent in January and February--as compared with the first two months of last year. With shipments up, we believe both industries will continue to spend heavily to increase domestic production of parts and components now procured from Japanese suppliers, further boosting growth at home. [redacted]

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Beyond 1988, the gradual appreciation of the won now under way is likely to slow exports, holding growth closer to 6 percent through 1990. [redacted] the Economic Planning Board is contemplating a 15-percent rise in the won against the US dollar this year, and private forecasters expect gradual appreciation to continue through 1992. [redacted]

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The labor situation--and thus the effect of wages on growth--remains a wild card in any estimate of the South Korean economy. Forecasters are assuming wage increases of 10 to 15 percent this year, but the spring wage negotiations--which will continue into May--could produce some higher settlements. Collective bargaining--a result of labor reforms last year--is new to the Koreans, and there are no established pattern setters for wage agreements. Many labor representatives appear determined to see what deals their counterparts elsewhere make before committing themselves to a settlement. At least one agreement has fallen within the anticipated range, but it was in the labor-intensive textile industry, where employees undoubtedly are aware that too

big an increase would cause a loss of export competitiveness and jobs. The outcome in the auto and electronics industries, where business is good, is less certain. [redacted] 25X1

Like almost all forecasters outside the South Korean Government, we expect Seoul's current account surplus, which was about \$10 billion in 1987, to grow slightly this year. Most of the increase is likely to show up in the services balance. Increased tourism and demands on transportation will boost revenues during the Olympics. At the same time, repayment of foreign debt--it should drop to under \$29 billion this year--will reduce interest payments. By 1989, we expect the surplus to begin to fall, as the higher prices of Korean goods produced by won appreciation begin to stem the rise of export volume and Seoul's measures to open the domestic market to foreign goods boost imports. The current account probably will reach \$5-7 billion in 1991. By the end of 1991, South Korea's foreign assets may surpass its remaining debt, making Seoul a net creditor to the world. [redacted] 25X1

Implications for the United States

The expected fall in South Korean export growth should help ease trade friction, which has become a significant irritant in US-South Korean relations. Seoul's efforts to diversify import sources away from Japan--the stronger yen has made reliance on Japanese materials, parts, components, and capital goods a burden for Korean industry--also should increase imports from the United States. [redacted] 25X1

In the security arena, we doubt Seoul will be willing to assume more of the burden of supporting US forces in South Korea. Korean defense officials probably will argue that any increases in the defense budget are needed to fund the development and acquisition of new weapon systems to offset North Korea's quantitative advantage in arms. The South Koreans may have a new source of funds, however. Won appreciation reduces the cost of foreign weapons or components used in domestically assembled systems. Seoul also pays less for imported fuels consumed by the military. We do not have enough detail on the Korean defense budget to know whether the savings on the Korean side would be sufficient to compensate for the currency-driven rise in costs to the United States of goods and services procured in South Korea. Labor costs, in particular, are likely to soar as the effects of won appreciation are added to the upward trend in wages. [redacted] 25X1

SOUTH KOREA'S ECONOMY: SHIFTING OUT OF OVERDRIVE

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